BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
CREDO DEVELOPERS, INC.)

Appearances:

For Appellant: Lawrence S. Kartiganer
Attorney at Law

For Respondent: Charlotte A. Meisel
Counsel

OP_I_N_I_ON

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Credo Developers, Inc., against a proposed assessment of additional franchise tax in the amount of $10,928 for the income year ended July 31, 1978.

The central issue presented for determination is whether appellant is entitled to a bad debt deduction in the amount of $123,987 for the income year ended July 31, 1978. If not, we must then decide whether appellant has established that the money so advanced (i.e., $123,987) constituted a "security" which became worthless during the same income year so as to be deductible.

Appellant is a California corporation which is a wholly owned subsidiary of Vaco Developers, Inc. (hereinafter "Vaco"). Vaco also owns 100 percent of Avanti, Inc. (hereinafter "Avanti"), which, during the period at issue, in turn owned 31.65 percent of Jiffy Food Store Company (hereinafter "Jiffy"), operator of a chain of convenience stores. During this time, Vernon Pudwill owned 90 percent of the stock of Vaco and was the president of Vaco, Avanti, and appellant, and the secretary of Jiffy.

During the early part of 1977, Jiffy experienced severe cash flow problems. In an effort to alleviate these problems, appellant advanced Jiffy significant sums of money. On March 15, 1977, appellant advanced Jiffy $25,000 in cash, and the parties executed a note for repayment of this amount and the payment of ten percent interest. One month later, Jiffy was advanced a total of $28,200 from appellant under essentially the same terms. At the same time, Jiffy repaid appellant $14,273. On or about October 1, 1977, appellant advanced Jiffy $45,059.74 for leasehold improvements. However, no note was executed by the parties for that advance until July 1, 1978. Appellant explained that at the time the leasehold improvements were made, final cost figures were not available, and that those figures were only determined in early 1978. When Jiffy was unable to pay the amount appellant had advanced for those improvements, the parties executed the July 1, 1978, note. On February 21, 1978, appellant advanced Jiffy another $40,000, and the parties executed two notes for $20,000 each pursuant to essentially the same terms as the previous advances.

Each of the advances was purported to be secured by the assets of Jiffy, as evidenced by a security agreement dated March 24, 1978, well after the time of the actual advances. However, this security agreement was not then filed with the Secretary of State, but instead, pursuant to an agreement with one of Jiffy's creditors, it was filed later, so that the other creditor might file its agreement first and thus have priority.

In addition to the repayment made by Jiffy on April 15, 1977, noted above, Jiffy repaid some of the advances, but because of continued cash flow problems, Jiffy was unable to repay all such advances. By May of 1978, the total outstanding amount of the principal advanced was **$123,966.69.** As Jiffy's financial situation had not improved, its stockholders and creditors requested that Jiffy's independent accounting firm prepare interim financial statements for the company. Those statements, dated July 19, 1978, indicated that Jiffy had an accumulated deficit of $586,648, an excess of liabilities over assets of $133,793, and a net operating loss of $483,367 for the nine months ending April 30, 1978. Based on these statements, appellant concluded that Jiffy was hopelessly and totally insolvent and, therefore, deducted $123,987 as a bad debt deduction for its income year ended July 31, 1978.

Indeed, on March 9, 1979, Jiffy filed a petition in bankruptcy court, and, pursuant to a plan of reorganization, on March 6, 1980, Jiffy was taken over by Frontier Trading, Inc. While, pursuant to this plan, Jiffy's creditors were to be paid in whole or in part, the sums owed to appellant and the related corporations, **Avanti** and **Vaco,** as well as to Mr. Pudwill, were waived.

Upon audit, respondent disallowed the bad debt deduction claimed by appellant in the income year ended July 31, 1978. Initially, respondent contended that appellant had not established that the event establishing worthlessness had occurred by the end of the income year at issue. Later, respondent also contended that the money advanced was not a loan but a contribution to capital. On appeal, appellant, of course, contested these two allegations. In addition, appellant now contends that even if respondent is correct that the money advanced was a contribution to capital rather than a bona fide loan, it is entitled to a deduction in a similar amount (i.e., $123,987) as a loss **from** worthless securities for the same income period. Respondent, on the other hand, apparently contends that appellant has not properly established its entitlement to a worthless security loss for the period at issue.

To support its contention that the amount advanced to Jiffy is deductible as a bad debt, appellant relies upon section 24348 of the Revenue and Taxation Code.' That section provides for the deduction of "debts which become worthless within the income year." Only a bona fide debt qualifies for purposes of that section.

A contribution to capital does not. (Appeal of Lambert-California Corporation, Cal. St. Bd. of Equal., June 29, 1982.)

Whether an advance to a corporation by a related entity is a capital contribution or a loandeductible as a bad debt is a question of fact upon which the taxpayer has the burden of establishing the right to a deduction. (White v. United States, 305 U.S. 281 [83 L.Ed. 172] (1938); Diamond Bros. Company v. Commissioner, 322 F.2d 725 (3d Cir. 1963).) Although the courts have stressed a number of factors which are to be considered in determining the nature of such advances, the basic inquiry is often formulated in terms of whether the funds were placed at the risk of the corporate venture, or whether there was reasonable expectation of repayment, regardless of the success of the business. (See Benjamin D. Gilbert, ¶ 56,137 P-H Memo. T.C. (1956), 248 F. 2d 399 (2d Cir. 1957), on remand, ¶ 58,008 P-H Memo. T.C. (1958), affd., 262 F.2d 512 (2d Cir. 1959), cert. den., 359 U.S. 1002 [3 L.Ed.2d 1030] (1959); Appeal of George E. Newton, Cal. St. Bd. of Equal., May 12, 1964.)

Debt, as distinguished from capital investment, may be defined for tax purposes as "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date, along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof." (Gilbert v. Commissioner, supra, 248 F.2d at 402.) While indicia of a debtor-creditor relationship is a major factor in determining whether such a relationship has actually been estabished, the courts have stressed that the "substance" rather than the "form " of a purported loan transaction is determinative. (United States v. Henderson, 375 F.2d 36 (5th Cir. 1967); American-LaFrance-Foamite Corp. v. Commissioner, 284 F.2d 723 (2d Cir. 1960).)

With respect to the instant appeal, the record indicates that the advances at issue were, in effect, unsecured, despite Jiffy's very tenuous financial condition. While a security agreement was prepared well after the bulk of the money had been advanced, it was not filed until any chance of priority had been lost. By appellant's own admission, appellant was aware of Jiffy's financial troubles, and the money was advanced to alleviate Jiffy's cash flow problems. Advances made under such circumstances evidence an intent to invest capital. (Appeal of Lambert-California Corporation, supra; Appeal of George E., Jr., and Alice J. Atkinson, Cal. St. Bd. of Equal., Feb. 18,

1970.) In light of its financial troubles, it seems unlikely that an objective creditor would have made an unsecured loan to Jiffy.

Under these circumstances, we must conclude that the advances in issue constituted capital which appellant contributed to its related corporation in order to reduce the losses Vaco would sustain should Jiffy be forced out of business. Therefore, appellant is not entitled to a bad debt deduction with respect to the subject advances. (Appeal of Lambert-California Corporation, supra.)

This conclusion makes it necessary to consider appellant's alternative allegation that it was entitled to a worthless security loss for the period ending July 31, 1978, for the amounts advanced.

Section 24347 of the Revenue and Taxation Code provides for the deduction of the loss from any security which becomes wholly worthless during the taxable year. A note or other evidence of indebtedness may be considered to be a security for purposes of section 24347. (Cal. Admin. Code, tit. 18, reg. 24347-5, subd. (a)(3).) The burden, of course, is on the taxpayer to establish that the securities became totally worthless during the year for which the deduction is claimed. (Boehm v. Commissioner, 146 F.2d 553 (2d Cir.), affd., 326 U.S. 287 [90 L.Ed. 78] (1945); Mahler v. Commissioner, 119 F.2d 869 (2d Cir.), cert. d-14 U.S. 660 [86 L.Ed. 529] (1941); Appeal of Harry E. and Mildred J. Aine, Cal. St. Bd. of Equal.! April 22, 1975.) In order to qualify for the deduction, the loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. (Cal. Admin. Code, tit. 18, reg. 24347-1, subd. (b).) Ordinarily, a taxpayer must establish that the stock had some value at the beginning of the year and became worthless during the taxable year. Furthermore, the taxpayer must prove not only that the securities had no current liquidating value at the close of the year, but also that it had no potential value. (5 Mertens, Law of Federal Income Taxation, § 28.65 (1980 Revision).)

In the instant appeal, appellant has simply not met its burden of establishing those facts required to deduct the advances during the period at issue. In short, appellant has not established what, if any, value the securities had at the beginning of the year or what their liquidating value or potential value was at the close of the year. Assuming, arguendo, that appellant

had established that its Jiffy securities had value as of August 1, 1977, it would still have to show some identifiable event between that date and July 31, 1978, which rendered the securities valueless. The financial statements prepared by Jiffy's independent accountant dated July 19, 1978, appear merely to indicate Jiffy's financial difficulty and do not evidence worthlessness during the period at issue. Moreover, appellant's apparent reliance upon the fact that in March of 1980, Jiffy was taken over by another company and that the sums owed to appellant were waived would not affect the period at issue. (Appeal of Baingo Brothers, Inc., Cal. St. Bd. of Equal., Oct. 28, 1980.)

Accordingly, we find that appellant has not borne its burden of showing what value the Jiffy securities had at the beginning of the period at issue or what identifiable event occurred during that year which resulted in the worthlessness of those securities. Therefore, we must also sustain respondent's action on this issue.

Appeal of Credo Developers, Inc.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Credo Developers, Inc., against a proposed assessment of additional franchise tax in the amount of $10,928 for the income year ended July 31, 1978, be and the same is hereby sustained.

Done at Sacramento, California, this 28th day of February, 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis, Mr. Bennett and Mr. Harvey present.

Richard Nevins, Chairman

Ernest J. Dronenburg, Jr., Member

William M. Bennett, Member

Walter Harvey*, Member

_____, Member

*For Kenneth Cory, per Government Code section 7.9